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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-593

CENTRAL TABLET MANUFACTURING CO.,
Petitioner,

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion and order of the district court in this case (R. 54)[1] is reported at 338 F. Supp. 1134. The opinion of the court of appeals (R. 57) is reported at 481 F. 2d 954.

JURISDICTION

The judgment of the court of appeals was entered on July 12, 1973 (R. 57). The petition for a writ of certiorari was filed on October 3, 1973, and certiorari was granted on December 17, 1973 (R. 58). The jurisdiction of this Court rests on 28 U.S.C. 1254 (1).

[1] "R" references are to the separately bound record appendix.

QUESTION PRESENTED

The question presented is whether proceeds from disputed fire insurance claims accepted and paid by insurers to taxpayer after adoption by taxpayer of a plan of complete liquidation are entitled to the application of the nonrecognition of gain or loss provisions of Section 337 (a) of the Internal Revenue Code of 1954, where the fire giving rise to the insurance claims occurred before adoption of the plan of liquidation.

STATUTE WHICH CASE INVOLVES

Internal Revenue Code of 1954 (26 U.S.C. §337):

§337 Gain or loss on sales or exchanges in connection with certain liquidations.

(a) General rule.—if—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

STATEMENT OF THE CASE[2]

Taxpayer was an Ohio corporation engaged in the manufacture and sale of writing tablets, school supplies, art materials and related items in Columbus, Ohio. On September 10, 1965, an accidental fire largely destroyed its equipment, machinery and buildings. The buildings

[2] The facts contained in this statement may be found in the Statement Of Uncontested Facts And Of The Issues filed in the district court in this case (R. 31-36).

of taxpayer were never rebuilt or repaired and the manufacturing equipment was never replaced or repaired following the fire.

At the time of the fire taxpayer carried fire and extended coverage insurance on its buildings and machinery, and business interruption insurance. Negotiations of taxpayer's claim for business interruption loss began on approximately October 8, 1965. Negotiations of the claims for building and equipment and personal property losses began on approximately November 1, 1965. Disputes arose regarding the applicability of a co-insurance clause contained in the building insurance policy, the extent of building loss, the value of the building at the time of loss, the value of the machinery and equipment that was lost or damaged, and the cost of repair of repairable machinery and equipment. On May 14, 1966, the shareholders of taxpayer adopted a plan of dissolution and complete liquidation. On approximately May 20, 1966, taxpayer accepted a settlement of its building insurance claim which was paid to it on or about June 15, 1966. On approximately August 25, 1966, taxpayer accepted a settlement of its personal property insurance claim, which was paid to it on or about November 17, 1966.

On May 3, 1967, all remaining assets after liquidating distributions to shareholders were transferred to a national bank as trustee to meet claims against taxpayer and taxpayer was dissolved under Ohio law.

Taxpayer's business interruption loss claim was settled on or about August 25, 1967, and received on or about September 22, 1967.

Claiming the application of Section 337 (a) of the Internal Revenue Code of 1954, taxpayer did not report the gain realized (the difference between the basis of its

assets and the amount of insurance received) upon the involuntary conversion of its property as a result of the fire on September 10, 1965. The Commissioner determined that §337 was inapplicable because the fire occurred before adoption of the plan of liquidation and made a deficiency assessment against taxpayer for additional tax as a result of the gain realized from the involuntary conversion.

Taxpayer paid the additional tax and filed a claim for refund which was disallowed. Thereafter, an action was filed in the District Court for the Southern District of Ohio, under 28 U.S.C. §1346 (a), for recovery of the additional tax. The District Court held that the realized gain from this involuntary conversion was within the nonrecognition provisions of §337 and entered judgment for taxpayer. The Government appealed and the court of appeals reversed.

SUMMARY OF ARGUMENT

I

Section 337 is a remedial statute enacted as part of the Revenue Act of 1954 to eliminate the need for determining whether the sale of assets in the course of a corporate dissolution was made by the corporation or by the stockholders after distribution of the assets in liquidation. By removing this determination, the statute also eliminates the basis for taxing both the corporation and the stockholders for the same "sale or exchange" transaction.

The cases have uniformly held that an involuntary conversion by casualty is to be treated as a "sale or exchange" under Section 337. *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. of Cl. 1960); *Covered Wagon, Inc.* v. *Commissioner*, 369 F. 2d 629 (8th Cir. 1966); cf. *Kent Manufacturing Corporation* v. *Com-*

missioner, 288 F. 2d 812 (4th Cir. 1961). And more recently it was held — *United States* v. *Morton*, 387 F. 2d 441 (8th Cir. 1968); *Kinney* v. *United States*, 73-1 USTC, ¶9140 (D. C. Cal. 1972) — that fire insurance proceeds received after adoption of a plan of dissolution from a fire occurring before adoption of the plan are entitled to nonrecognition of gain treatment under Section 337 (a).

It is submitted that *Morton* and *Kinney* were correctly decided and are dispositive of the case at bar.

II

Although an involuntary conversion by casualty may not be literally a sale or exchange, it (like an involuntary conversion by condemnation) is the same kind of transaction wherein property is converted into cash or other proceeds. The tax consequences which arise depend upon the gain or loss resulting to the taxpayer.

Conversion in a sale or exchange occurs at the point at which the right to receive cash or other proceeds becomes fixed. In a true sale this occurs when the obligation of the seller to sell and the purchaser to buy is unconditional. Treas. Reg. §1.337-2 (a). In an eminent domain proceeding the passing of title is normally held to determine the rights of the parties.[3] *West Street-Erie Boulevard Corporation* v. *United States*, 411 F. 2d 738 (2nd Cir. 1969); *Covered Wagon, Inc.* v. *Commissioner*, 369 F. 2d 629 (8th Cir. 1966); *Wendell* v. *Commissioner*, 326 F. 2d 600 (2nd Cir. 1964).

By a parity of reasoning, an involuntary conversion by casualty of insured property cannot have occurred until

[3] Under laws permitting the condemnor to take immediate possession of the property, the time of possession may establish the rights of the parties for tax purposes. See *Best* v. *Humboldt Placer Mining Co.*, 371 U.S. 334 (1963); *United States* v. *Dow*, 357 U.S. 17 (1958).

some right, at least, to insurance proceeds is agreed upon or otherwise established. *United States* v. *Morton, supra*; *Kinney* v. *United States, supra*. And certainly this is not, as the decision of the court of appeals in this case would make it, at the time of the casualty in every instance.

Under the *Central Tablet* facts, the right to insurance proceeds did not accrue and the conversion did not occur until acceptance by the insurer, following adoption by taxpayer of a plan of liquidation, of the proof of loss. The decision of the court of appeals on the facts of this case is in error.

ARGUMENT

I

I. An Involuntary Conversion by Casualty is Within the Class of Transactions Congress Sought to Reach With the Enactment of Section 337.

Section 337 provides for the nonrecognition of gain or loss from the sale or exchange of property by a corporation for a period of twelve months after the adoption of a plan of complete liquidation. Its enactment followed decisions by this Court in *Commissioner* v. *Court Holding Co.*, 334 U.S. 331 (1945)[4] and *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950)[5], and was intended to eliminate the formalities of sales or exchanges in corporate liquidations as the basis for taxing either the stockholders alone (*Cumberland Public Service*) or both the corporation and the stockholders

[4] Holding the gain from the sale of the single asset of a corporation by its two stockholders following transfer of the asset to them in liquidation was taxable to the corporation.

[5] Holding gains from sales by stockholders of property received in a general liquidation distribution were not taxable to the corporation.

(*Court Holding*) for substantially the same gain producing transaction.[6]

Its purpose is well stated in *Manilow* v. *United States*, 315 F. Supp. 28, 32 (N.D. Ill), as follows:

> "Congress enacted Section 337 as a remedial provision to eliminate double taxation by imposing only one tax at the shareholder level upon gains resulting from a complete corporate liquidation. The House and Senate Reports concerning this provision manifest a clear intent to eliminate the technicalities found to be of significance by the courts as the basis for taxing both the corporation and the shareholders or just the shareholders for substantially the same transaction."

Beginning with *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. of Cl. 1960)[7], it has been held in an unbroken line of cases that involuntary conversions, whether by condemnation[8] or casualty[9], are encompassed within the language "sale or exchange" as used in Section 337. The Internal Revenue Service has acquiesced in this view — Rev. Rul. 64-100.

It was more recently held in *United States* v. *Morton*,

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[6]This Congressional intent is evidenced in the statement in Hse. Rept. No. 1337, 83rd Cong. 2d Sess. 38 (3 U.S. Code Cong. & Adm. News 1954, p. 4244), that: "* * * Accordingly, under present law, the tax consequences arising from sales made in the course of liquidation depend primarily upon the formal manner in which transactions are arranged. The possibility that double taxation may occur in such cases results in causing the problem to be a trap for the unwary."

[7]In *Towanda*, the court reasoned that: "Literally, an involuntary conversion is not a sale but what Congress had in mind was a conversion of a corporation's capital assets into cash, whether voluntary or involutary, and the distribution of cash to the stockholders" (180 F. Supp. 376).

[8]*Dwight* v. *United States*, 328 F.2d 973 (2nd Cir. 1964); *Covered Wagon, Inc.*, v. *Commissioner*, 369 F.2d 629 (8th Cir. 1966).

[9]In *Kent Manufacturing Corporation* v. *Commissioner*, 288 F.2d 812 (4th Cir. 1961), it was held that a "sale or exchange" for the purposes of the operation of §392 (this section provides a special rule for liquidations occurring between June 22, 1954 and December 31, 1954) includes involuntary conversions of property by casualty.

387 F. 2d 441 (8th Cir. 1968), in further application of Section 337 to involuntary conversions, that fire insurance proceeds received after adoption of a plan of liquidation from a fire occurring before adoption of the plan constituted a nonrecognizable gain under the statute.[10]

The court of appeals below expressly declined to follow *Morton*, holding, in effect, that an involuntary conversion by casualty for the purpose of the application of Section 337 occurs in every case at the instant of the casualty. Contrary to this rule, it is the position of taxpayer that an involuntary conversion is not a single act, but, like an ordinary sale or an exchange, is a transaction which is complete when gain or loss is determined, or is reasonably determinable from the conditions of the transaction — whether they be written or arise from the surrounding circumstances.

II

II. The Court of Appeals Erred in Holding That For the Purposes of the Operation of Section 337 the Gain From an Involuntary Conversion of Property by Casualty Occurs at the Time of the Casualty.

Section 337 operates upon gain or loss from sale or exchange transactions in the course of corporate liquidations. It follows that for purposes of the statute a sale or exchange occurs at that point in time at which the events producing the gain or loss are no longer uncertain. In a

[10] The full import of *Morton* is that a "sale or exchange" by involuntary conversion is not completed until either the policy proceeds are received or an enforceable settlement of a determined amount is agreed upon or a court judgment obtained. (387 F.2d 448). In the more recent case of *Kinney v. United States*, 73-1 USTC ¶9140, decided after the decision by the court of appeals in this case, the court reached the same result reasoning that the involuntary conversion did not occur until the insurer's receipt and acceptance of the proof of loss which postdated the adoption of the plan of liquidation.

conventional sale this happens when an unconditional contract is reached by the parties.[11] In a condemnation, it is held to occur upon passage of title to the condemnor. *Covered Wagon, Inc.* v. *Commissioner*, 369 F. 2d 629 (8th Cir. 1966). In an involuntary conversion by casualty it can be no sooner than the establishment of some formula for the measurement of insured losses.[12]

Relying largely on the condemnation cases, the Government's argument has been, in effect, that "sale or exchange" within the meaning of Section 337 is a title rather than a transactional concept. The further argument has been that the involuntary conversion counterpart of the passing of title in condemnations is the casualty itself which is the event that deprives the taxpayer of use and ownership of the property and converts it into a claim for compensation.

The comparison, however, is always with eminent domain proceedings in which, by local law, title passes upon the filing of the declaration of taking, or an equivalent filing.[13] And as the counterpart of this initial

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[11] Treas. Reg. §1.377-2 (a) provides: "Provided the other conditions of section 337 are met, sales or exchanges which occur on or after the date on which the plan of complete liquidation is adopted and within the 12-month period thereafter are subject to the provsions of such section. The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both, shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional."

[12] In the case at bar, the original proofs of loss were summarily rejected by the insurer (R. 25, 48). In addition there was disagreement as to the applicability of a co-insurance clause (R. 23, 33).

[13] Under what may be a majority of statutes title does not pass until an award is made or received. 26 Am. Jur. 2d, Eminent Domain §131, p. 790. See also *The Mountain Water Co. of Crescenta* v. *Commissioner*, 35 T.C. 418 (1960).

declaration or filing, the Government fastens upon the happening of the earliest event in the chain of events in an involuntary conversion by casualty transaction — the casualty — as likewise determining the time of the "sale or exchange".

But it is not the formality of the passing of title in condemnation cases that fixes this as the point at which the sale or exchange occurs for tax purposes, but the fact that at this point the obligations of the parties become unconditional. Cf. *Best* v. *Humboldt Placer Mining Co.*, 371 U.S. 334 (1963); *United States* v. *Dow*, 357 U.S. 17 (1958). And the event in an involuntary conversion which parallels the passing of title in a condemnation proceeding is the acceptance by the insurer of the proof of loss. The casualty on the other hand is more nearly like an executory contract of sale (Treas. Reg. §1.337-2 (a) footnote 11, above) — the initial act which sets in motion the conversion producing forces.

Furthermore, the conversion in a property loss by casualty is not the transformation of the property into an unproven insurance claim, but the transmutation of the property into money.[14] Under the facts of *Central Tablet*, the definitive event of this alchemy was acceptance by insurer of taxpayer's proof of loss. The reasoning of the

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[14] In *Helvering* v. *Hammel*, 311 U.S. 504, 512 (1941) in a case arising under §117 (d) of the Rev. Act of 1939, this Court, in a not dissimilar situation, held: "Respondents also advance the argument, sustained in *Commissioner* v. *Freihofer*, 102 F.2d 787, that the definitive event fixing respondents' loss was not the foreclosure sale but the decree of foreclosure which ordered the sale and preceded it. But since the foreclosure contemplated by the decree was foreclosure by sale and the foreclosed property had value which was conclusively established by the sale for the purposes of the foreclosure proceeding, the sale was the definitive event establishing the loss within the meaning and for the purpose of the revenue laws. They are designed for application to the practical affairs of men. The sale, which finally cuts off the interest of the mortgagor and is the means for determining the amount of the deficiency against him, is a means adopted by the statute for determining the amount of his capital gain nor loss from the sale of the mortgaged property."

court in *Kinney* v. *United States, supra,* is equally valid applied to *Central Tablet:*

> "* * * The same reasoning [the reasoning of the condemnation cases that upon passage of title an enforceable right to an exact award comes into being] supports the result reached in this case, an involuntary loss case, since no right to proceeds exists prior to the insurer's receipt and acceptance of the proof of loss, which postdated the adoption of the plan [of dissolution]. "(73-1 USTC, 80, 131)

Although the court in *United States* v. *Morton, supra,* came out at a different point in the sequence of events totaling the conversion, its decision supports the position of taxpayer here:

> "* * * Since no title is involved in a fire loss case of this type, we think the catastrophe is but the commencement of an involuntary conversion that does not come into fruition until, at least, the amount to be received by way of reimbursement for that loss is decided either by agreement or by court action. The payment date is significant for tax purposes in figuring gain but might not be the significant date insofar as the date of 'sale or exchange' of an involuntary converted capital asset is concerned. This would not take place until at least there was a court judgment awarding a determined fixed amount or else the parties had come to a settlement agreement on the amount of the loss, which the insurance company would be legally liable to pay in a fixed amount without any further action being necessary on the part of the taxpayer." (387 F. 2d 447)

There is no basis, legal or equitable, for holding that the casualty is in all cases the point at which an involuntary conversion occurs for the purpose of the application of Section 337 — the thrust of the court of appeals decision below. Such a holding, from a practical standpoint, excludes involuntary conversions by casualty from the

remedial operation of the statute[15] and places taxpayers back in the *Court Holding*[16] trap.

The aim of the courts ought not to be to narrowly define the reach of the statute to exclude transactions, but to extend it to all situations fairly within the statutory design. The decision below cannot be squared with the design of Section 337.

CONCLUSION

The judgment of the court of appeals in this case should be reversed.

Respectfully submitted,

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January 1974

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[15] The few instances in which an accidental property loss will happen after adoption of a plan of dissolution can be of little significance to the tax question involved in this case.

[16] *Commissioner* v. *Court Holding Co.*, 334 U.S. 331 (1945).